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No. 78-660

In the Supreme Court of the United States

OCTOBER TERM, 1978

PLEASANTON GRAVEL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATFS COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The sole question presented in this federal income tax case is whether income petitioner received under a mineral lease agreement is royalties and therefore taxable as personal holding company income under Section 543(a)(3) of the Internal Revenue Code of 1954.

The pertinent facts may be summarized as follows: Petitioner, a corporation wholly owned by George Jamieson, purchased a tract of land from Jamieson in 1956. In 1959, petitioner and Jamieson Company, a partnership owned by George Jamieson and his father, entered into an agreement under which Jamieson Company was granted the right to extract rock, sand and gravel from petitioner's tract of land. Jamieson Company agreed to pay petitioner five cents per ton of rock, sand and gravel removed, plus an additional one cent per ton for each thirty cent increment by which the local

wholesale price exceeded $1.50 per ton.[1] The agreement contained no provisions for a minimum payment, minimum quantities of minerals to be extracted, or any other fixed obligation on the part of Jamieson Company. Jamieson Company retained the right to terminate the agreement, on 60 days notice, "[i]f at any time during quarrying operations Buyer [Jamieson Company] determines that rock, gravel and sand can no longer be profitably quarried and removed from the lands described in 'Exhibit A' hereto * * *" (Pet. App. 5).

On audit, the Commissioner of Internal Revenue determined that the income petitioner received from the gravel transfers was royalties and that petitioner was therefore a personal holding company under Section 542 of the Code because more than 60 percent of its adjusted ordinary gross income was personal holding company income. In response, petitioner took the position that it should have reported the income in question as capital gains and claimed refunds for each of the years at issue (Pet. App. 11).

The Tax Court held that under this Court's decision in *Palmer* v. *Bender*, 287 U.S. 551 (1933), petitioner retained an "economic interest" in the minerals excavated from its land so that any income derived under the agreement with Jamieson Company was not capital gain but royalties. It therefore upheld the Commissioner's determination that petitioner was a personal holding company (Pet. App. 19-29). The court of appeals affirmed per curiam (Pet. App. 40).

1. Petitioner contends (Pet. 4-5) that the decision below misapplied the economic interest test set forth in *Palmer* v. *Bender*, *supra*. There, the Court held that the taxpayer

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[1]In 1962, the parties amended the agreement to provide that Jamieson Company would receive a volume discount when more than one million tons were quarried in a given year (Pet. App. 6-7).

retains an economic interest in minerals[2] in place by investment[3] if it looks "*solely* to the extraction of * * * [the minerals] for a return of [its] capital." *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 314 (1956). See Treasury Regulations, Section 1.611-1 (26 C.F.R.).

Here, the agreement between petitioner and Jamieson Company shows that petitioner looked "*solely* to the extraction of * * * [the minerals] for a return of [its] capital." The only measure of petitioner's income was the amount of rock, sand and gravel excavated by Jamieson Company. Jamieson Company was under no obligation to extract any minimum amount of sand and gravel, was under no obligation to make any payment if it did not extract any minerals, and was free to terminate the agreement whenever it appeared that continued excavation would be unprofitable (Pet. App. 5). The provisions of the agreement convincingly refute petitioner's assertion (Pet. 4, 7) that there was an "unconditional sale" of the minerals.[4]

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[2]Although *Palmer* v. *Bender*, *supra*, involved oil and gas production, it is well established that the economic interest test likewise applies to the extraction of hard minerals. *Hartman Tobacco Co.* v. *United States*, 471 F. 2d 1327 (2d Cir. 1973) (en banc); *Oliver* v. *United States*, 408 F. 2d 769 (4th Cir. 1969); *Gitzinger* v. *United States*, 404 F. 2d 191 (6th Cir. 1968); *United States* v. *White*, 401 F. 2d 610 (10th Cir. 1968) (en banc); *Alkire* v. *Riddell*, 397 F. 2d 779 (9th Cir. 1968); *Schreiber* v. *United States*, 382 F. 2d 553 (7th Cir. 1967); *Wood* v. *United States*, 377 F. 2d 300 (5th Cir.), cert. denied, 389 U.S. 977 (1967). See also *Laudenslager* v. *Commissioner*, 305 F. 2d 686 (3d Cir. 1962); *Rabiner* v. *Bacon*, 375 F. 2d 537 (8th Cir. 1967).

[3]It is undisputed that petitioner acquired its interest by investment when it purchased the land from George Jamieson.

[4]The fact that the agreement here spoke of the transaction as a sale, and labeled the parties as "Buyer" and "Seller," is irrelevant. It is the substance, not the form, of the transaction which is controlling for tax purposes. *E.g.*, *Wood* v. *United States*, *supra*, 377 F. 2d at 311; *Royalton Stone Corp.* v. *Commissioner*, 379 F. 2d 298 (2d Cir.), cert. denied, 389 U.S. 978 (1967); *Oliver* v. *United States*, *supra*.

Petitioner further errs in contending (Pet. 6) that the rule of *Palmer* v. *Bender* is limited to those cases where the taxpayer obligates himself to permit the extraction of something less than 100% of the minerals on his land. Quite to the contrary, the economic interest test turns on whether the taxpayer's income is measured solely by the extraction of the minerals in place, without regard to a fixed total amount of minerals to be extracted. *Wood* v. *United States, supra.* See *Hartman Tobacco Co.* v. *United States, supra; Laudenslager* v. *Commissioner,* 305 F. 2d 686 (3d Cir. 1962); *Oliver* v. *United States,* 408 F. 2d 769 (4th Cir. 1969); *Hair* v. *Commissioner,* 396 F. 2d 6 (9th Cir. 1968); *Schreiber* v. *United States,* 382 F. 2d 553 (7th Cir. 1967); *Rabiner* v. *Bacon,* 373 F. 2d 537 (8th Cir. 1967).

2. Contrary to petitioner's further contention (Pet. 4, 6-7), the decision below does not conflict with either *Linehan* v. *Commissioner,* 297 F. 2d 276 (1st Cir. 1961), or *Rhodes* v. *United States,* 464 F. 2d 1307 (5th Cir. 1972). In *Linehan,* the excavator was under an affirmative duty to extract all of the minerals in place to a certain grade, *i.e.,* a fixed amount. Apart from this pivotal distinction, several courts of appeals have criticized *Linehan* on the ground that it failed to apply the economic interest test to hard minerals. See *Hartman Tobacco Co.* v. *United States, supra,* 471 F. 2d at 1329; *United States* v. *White, supra,* 401 F. 2d at 612; *Oliver* v. *United States, supra,* 408 F. 2d at 771; *Alkire* v. *Riddell,* 397 F. 2d 779, 780 (9th Cir. 1968); *Wood* v. *United States, supra,* 377 F. 2d at 309; *Laudenslager* v. *Commissioner, supra,* 305 F. 2d at 692 n.4. See cases cited at page 3, n.2, *supra.*

Rhodes is likewise distinguishable. There, the taxpayer entered into an agreement under which he received a flat $15,000 per two-acre parcel of land for the rights to the clay deposits. Unlike the agreement in this case, the

buyer's obligation in Rhodes was unconditional and the amount to be paid was in no manner dependent upon the extraction of the minerals in place.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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